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IN THE SUPREME COURT OF THE UNITED STATES.

October Term, 1946.

No. .....

No. .....

F. A. GILLESPIE AND SONS COMPANY, ***Petitioner,***

vs.

COMMISSIONER OF INTERNAL REVENUE, ***Respondent.***

PETITION FOR WRIT OF *CERTIORARI.*

To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

F. A. Gillespie and Sons Company, the petitioner herein, by John E. Hughes and Harold E. Rorschach, its attorneys, respectfully prays that the writ of *certiorari* issue to review the judgments of the United States Circuit Court of Appeals for the Tenth Circuit in cases Nos. 3180 and 3181 in said Circuit Court of Appeals.

Short and Summary Statement of the Matter Involved.

POINT I.

In 1935 and 1936 petitioner deducted in its income tax returns from gross income, depreciation on equipment used in the operation of oil wells and also deducted depletion on the oil wells. For 1935, this depreciation amounted to $1,466.27 and for 1936 to $4,611.61. Percentage depletion deducted for 1935 was $5,441.51 and $10,194.98 for 1936. For

1935, its net loss was $18,644.65 and for 1936, its net loss was $27,243.77. For this reason, petitioner received no tax or other benefit from said depreciation or depletion deductions (R. 27, 28), but when it sold the property in 1937, respondent added the amounts of the 1935 and 1936 depreciation and depletion deductions to the selling price and forced petitioner to pay income tax in 1937 on the amounts of said depreciation and depletion deductions for 1935 and 1936, purporting to follow the 5 to 4 decision of this Court in *Virginian Hotel Company* v. *Helvering,* 319 U. S. 523 (wherein The Tax Court's view was overturned). The Tax Court and the court below affirmed this action of the Commissioner relying on this Court's decision.

Because (as more fully stated herein under reasons for granting the writ) the aforesaid decision of this Court has been generally conceded to go too far and to produce results not intended by Congress and to require reversal by this Court or by the Congress, this petition is filed for the purpose of requesting this Court to reexamine and modify its aforesaid decision at least to the extent of negativing any inference that it authorizes adding, in a year property is sold, prior year deductions to the profit derived from the sale, which deductions neither benefited taxpayer nor prejudiced the revenue.

Facts Bearing on Point 2.

The taxpayer acquired the Placedo oil and gas leases prior to the year 1937 and in drilling oil wells thereon had capitalized its portion of the drilling and development costs (R. 26-27). The taxpayer sold its interest in the property in 1937 for $200,000 cash, and reserved from the sale 1/8 of the 7/8 of the oil and gas produced therefrom until $275,000 should be received by the petitioner (R. 26). In computing the profit on the sale the capitalized drilling and development costs were proportioned, a part to the in-

terest sold and a part to the interest retained (R. 28-33), based upon the appraised value of the interest retained (R. 28).

Facts Bearing on Point 3.

Pursuant to a contract entered into on May 15, 1929, (R. 169) between the petitioner and F. A. Gillespie and Maud Gillespie, husband and wife, the last two transferred to petitioner bonds and sundry property having a value of $1,464,240.22, the cost of which to the Gillespies equaled or exceeded the above value (R. 34).

Under the terms of this contract the petitioner agreed to pay F. A. Gillespie $15,000 per year for life and to pay Maud Gillespie $15,000 per year for life. The Tax Court had previously determined that F. A. Gillespie was taxable on the basis of $15,000 per year as representing the taxable portion of the annuity payment. The United States Circuit Court for the Ninth Circuit determined that Maud Gillespie was taxable on the sum of $5,896.13 per year representing the taxable portion of the annuity payment received by her (R. 36). The Tax Court, affirmed by the Circuit Court, determined that the taxable portion of the annuity payments did not represent interest and was not deductible as such by this petitioner (R. 37).

Facts Bearing on Point 4.

In the recomputation of the tax by The Tax Court under Rule 50 the depletion allowance for the years 1937 and 1939 were reduced by an added amount of estimated overhead expense which was a new issue raised by the Commissioner of Internal Revenue. (R. 40-41 and 278-280)

Opinions Below.

The memorandum opinion of The Tax Court is not published but is printed in the record at pages 25 to 39.

The opinion of the Circuit Court of Appeals (R. 299 to 307) is published in 154 F. (2d) 913.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered March 12, 1946 (R. 307). A petition for rehearing was timely filed (R. 308) and was denied May 23, 1946 (R. 313). On August 8, 1946, this Court extended the time to file this petition until October 15, 1946. The jurisdiction of this Court is invoked under Section 240 (2) of the Judicial Code, as amended by the Act of February 13, 1925.

The Questions Presented.

First Question.

May excessive deductions for depreciation in prior years from which a taxpayer derived no tax benefit be added to taxable profit when taxpayer sells the property?

May depreciation and depletion deductions for 1935 and 1936 which did not reduce taxpayer's tax in those years be added to the 1937 income and taxed as profit on the 1937 sale without being a direct tax and void because not apportioned as required by the Federal Constitution?

Do such 1935 and 1936 deductions constitute gain, profit or income in 1937 within Section 22(a) of the Internal Revenue Code[a] or the Sixteenth Amendment to the Constitution?

Second Question.

Are capitalized drilling and development costs in case of oil and gas properties part of the leasehold investment, and in the case of a sale, must an allocation be made upon an assumed or hypothetical basis of such capitalized drill-

[a] or Section 22(a) of the Revenue Acts of 1936 and 1938.

ing and development costs, between the interest retained and the interest sold?

THIRD QUESTION.

Are the interest portions of the payments made by the taxpayer to F. A. Gillespie and his wife under the annuity contract of May 15, 1929, which consists partly of a return of capital and partly of interest, deductible by the taxpayer in the year in which paid?

FOURTH QUESTION.

May new issues be introduced in the recomputation of tax under Rule 50 of The Tax Court?

Statutes and Regulations Involved.

Section 113 of the Revenue Acts of 1936 and 1938 (R. 303) provided:

> "*Adjusted Basis for Determining Gain or Loss.*
>
> "(a) The basis of property shall be the cost of such property.
>
> "(b) *Adjusted Basis.* The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired; shall be the basis determined under subsection (a), adjusted as hereinafter provided.
>
> "1. *General Rule.* Proper adjustment in respect of the property shall in all cases be made * * *
>
> "(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws."

There is nothing in the regulations casting any light on the meaning of the word "allowed." (Reg. 101, Art. 113(b)-1.) And hence nothing is quoted.

Section 111 of the Revenue Acts of 1936 and 1938 provided:

(a) *Computation of Gain or Loss.* The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in Section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.* The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) *Recognition of Gain or Loss.* In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of Section 112.

Section 23 of the Revenue Acts of 1936 and 1938 provided:

(b) *Interest.* All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) and interest upon which is wholly exempt from the taxes imposed by this title.

Reasons for Granting the Writ.

It is believed that when it is brought to the attention of this Court that in the preponderant opinion of the bar and of other experts on a subject, a decision of this Court is clearly wrong, this great Court will willingly re-examine and consider correcting such decision itself and not leave its correction to Congress which in the last ten years has reversed more tax decisions of this Court than any other decisions since this Court was created, and at any rate this Court will not permit the extension of such decision to a state of facts not presented therein.

Reversal of the (5 to 4) decision in *Virginian Hotel Company* v. *Helvering*, 319 U. S. 523, has been recommended by both the American Bar Association (see Reports of the American Bar Association, 1943, Vol. 68, pages 166 and 167, quoted in appendix to this petition) and by The American Institute of Accountants (see The Journal of Accountancy, December, 1944, page 460, also quoted in this appendix).

That Congress intended by the provision of the statute governing this question only to prevent the correction of depreciation deductions in cases where the Statute of Limitations barred the collection of additional tax, see the Committee Report (quoted in the brief to this petition) and see also 56 Harvard Law Review, page 1164.

The majority opinion of this Court in the *Virginian Hotel* case reversed the considered opinion of the expert Tax Court and placed a construction on the word "allowed" contrary to a published ruling of the revenue bureau (see annexed brief).

In all justice to the majority of this Court, we believe, despite the burden of its vast volume of business, it would not have rendered the decision it did had the question been as fully and lucidly presented as we propose to present it, should this Court, in view of the foregoing, deem this obviously important question worthy of reexamination by it.

While for the foregoing reasons we believe the question should be reexamined even when arising on the same state of facts, *a fortiori* it should not be extended to tax as 1937 profit such deductions made in 1935 and 1936.

In the *Virginian Hotel* case the property was not sold, as it was here, and the excessive prior year deductions had not, as here, been added to income in the year of sale (1937) and it was not open to that taxpayer to make the point,

which we make here—that the Sixteenth Amendment to the Constitution authorizes only a tax on "income," that income in a current year is not created by excessive and illegal deductions, taken in prior years which neither reduce net income, benefit the taxpayer nor prejudice the Treasury, and that the statute as construed and applied by the court below, is not authorized by the Sixteenth Amendment to the Constitution, but levies a direct tax in violation of Article 1, Section 2, Clause 3 of the Constitution.

Taxpayer has been taxed in 1937 on $21,624.37 depreciation and depletion deductions for 1935 and 1936. Taxpayer never received a cent on account of these paper deductions nor anything of exchangeable or other value. It would have been as well off if it had not taken them and was no richer by taking them. In short, *they were not income* in any year, much less in 1937. This Court should not sustain a 1937 income tax thereon. The statute can only be upheld if construed not to impose it. Furthermore this is not income within the definition contained in Section 22(a) of the Internal Revenue Code. Excessive deductions, in prior years, which did taxpayer no good and the revenue no harm, do not fall within the definition of "Gross Income" in Section 22(a) of the Internal Revenue Code.

All of which is respectfully submitted.

JOHN E. HUGHES,
105 W. Adams St.,
Chicago, Ill.,
HAROLD E. RORSCHACH,
Kennedy Bldg.,
Tulsa, Okla.,
Counsel for Petitioner.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF *CERTIORARI.*

A statement of the opinions below, jurisdiction and question presented is contained in the foregoing petition and is not repeated here.

Statement of the Case.

To the statement of the case contained in the foregoing petition, we add that The Tax Court refused to consider the uncontradicted evidence that excessive depreciation had been deducted in prior years because it considered this immaterial under the decision of this Court in the *Virginian Hotel* case. (R. 30)

A depreciation deduction is not "allowed" merely because no action on it is taken by the Commissioner.

Usually income tax returns disclosing a net loss are not sent to the field to be audited. Depreciation questions are handled by the Engineering or Valuation Section (Paul & Mertens, Vol. 5, Sec. 42.30) and where the affirmative disallowance of the entire deduction for depreciation would still leave a net loss, the depreciation question is not examined (Mimeograph 4170; C. B. XV-2, pp, 148, 149). In such case the deduction is neither allowed nor disallowed.

A deduction not considered is no more allowed than a claim filed in the Court of Claims or in any government department is "allowed" where it has not been acted on by the court or by the government bureau. Surely, a petition for certiorari or rehearing is not "allowed" in this Court where it has not been acted on. If so, why is a depreciation deduction allowed where not acted on?

Also, deductions are only such as are allowed by Section 23 of the Code and it does not allow and the Com-

missioner has no authority to allow an excessive deduction, depreciation or otherwise.

In S. M. 4249, C. B. IV-2, p. 15, the bureau ruled:

> "A deduction is not 'allowed' until it is passed upon and approved by the Commissioner."

See also G. C. M. 8573, C. B. IX-2, p. 168; G. C. M. 10754, C. B. XI-2, p. 177; G. C. M. 18611, C. B. 1937-1, p. 235.

Furthermore, the sole reason for the inclusion of the statutory provision here in question was to prevent taxpayers getting a double tax benefit by correcting excessive deductions for prior years after the right of the government to collect the tax they saved in prior years by such excessive deductions was outlawed. Senate Report 665, at page 29, states "the treasury should not be penalized for having approved taxpayer's deductions." See also 56 Harvard Law Review, p. 1164. See also Mertens, Volume 3, pages 637-638.

Also, this case is distinguishable from the *Virginian Hotel* case because here the excessive depreciation for prior years has been added to 1937 income and an income tax for 1937 imposed thereon, and we submit this is not income and that an income tax is not authorized by the Sixteenth Amendment to the Constitution on anything but income. Deductions for the year in issue, which alone were involved in the *Virginian Hotel* case, may depend on legislative grace, but adding an item to and taxing it as income in a year it was not deducted is another matter.

Certain it is that the ordinary citizen or the ordinary man who voted for the Sixteenth Amendment would not consider the amount of an excessive and illegal deduction in a prior year, which did not benefit the taxpayer or harm the revenue, to be taxable as income in a subsequent year. It is not "income" in any sense of the word.

Point II.

Where the taxpayer sells an oil and gas lease in which it has an investment in capitalized drilling and development costs and it retains an interest in the oil and gas to be produced from the lease until a specified amount is returned to it, the investment in capitalized drilling and development costs should not be prorated upon the ratio existing between the value of the interest sold and the value of the interest retained.

In view of the fugacious nature of oil and the necessarily contingent nature of oil payments to be received from the production of oil, if any, an allocation of drilling cost between cash received and the oil payments to be received out of production may result in taxpayer's failure to recover its drilling and development costs so allocated. If cost be not recovered, the taxation of a portion of the cash received as gain realized on the sale, would in effect be a tax upon capital and not upon income.(1)

The receipt of cash from the retained oil payment is so conjectural that its fair value cannot be included as a part of the gain realized from the sale, and the practical solution, is to first permit recovery of cost to the extent of cash received. This solution guarantees that the taxpayer at least will recover its cost to the extent of cash received and recovery of cost will not be dependent upon a wholly conjectural possibility. Thus the constitutional inhibition against the taxation of capital as income is preserved.

If tax laws are to be administered in a practical manner and upon an annual accounting basis, the taxpayer has realized gain on the sale of the oil leases for the taxable years 1937 and 1939 only to the extent of the cash received in excess of its costs. Any formula for the allocation of costs, however just and equitable though it may appear to be, which forces this taxpayer to postpone a recoupment of

(1) *Burnet* v. *Logan*, 283 U. S. 404, 75 L. ed. 1142; cf. *Thomas* v. *Perkins*, 301 U. S. 655, 81 L. ed. 1324.

its investment to the happening of unpredictable future events, which may never occur, is a direct violation of the Sixteenth Amendment and the Revenue Acts enacted pursuant thereto, which lay a tax upon income and not capital.

Point III.

Payments made by the taxpayer to the Gillespies under the contract of May 15, 1929, consist partly of the return of capital and partly of interest. The portion consisting of interest is deductible by the taxpayer in the year paid.

In deciding against the petitioner on the above issue the court below is in conflict with the Second Circuit in the case of *New England Life Insurance Co.* v. *Welch,* 153 F. (2d) 260;[2] the Second Circuit Court stating that where the taxpayer enjoys the use of money or some part of it over a period of postponement, and for this use it pays a compensation, then, in the ordinary parlance of the business world this payment would be called "interest on indebtedness," even though no obligation to pay anything arises until an installment falls due; and money owing constitutes indebtedness and the hire paid for it is commonly called interest during the time agreed for the loan to run as well as after that time has passed. In the former situation interest is compensation for the use of the money. In the latter it is compensation for the detention of it. But in both situations it is "interest on indebtedness" and deductible as being within the definition of "interest on indebtedness" as provided by statute.

(2) The Solicitor General appears to consider this decision as correctly stating the law as he announced no petition for *certiorari* would be filed. Prentice Hall Tax Service, April 4, 1946, par. 71063.

Point IV.

The court erred in redetermining the depletion allowance for the year 1937 and reducing said allowance in the amount of $2,181.73 and redetermining the depletion allowance for the year 1939 and reducing the allowance in the amount of $1,878.55.

The court erred in redetermining the depletion allowance for the year 1937, reducing the allowance for that year from $35,158.94 to $32,977.21 (R. 41-45) and in redetermining the depletion allowance for the year 1939, reducing the allowance set out in the 90-day letter from $36,699.72 to $34,821.17, (R. 278-281) said reduction being occasioned by an estimated additional overhead deduction. This issue was neither raised in the petitions nor was an affirmative plea made by the Commissioner of Internal Revenue in his answers with respect thereto, nor was any evidence offered in support thereof.

This reduction in the depletion allowance was a new issue which may not be raised after trial under a Rule 50 computation and is in conflict with the case of *Bankers Pocahontas Coal Co.* v. *Commissioner,* 287 U. S. 308, 77 L. ed. 325.

For the foregoing reasons, the writ should be granted and the case reversed with directions to The Tax Court to decide the amount of the excessive deductions in prior years and hold such amount not taxable in 1937, and also to apply the tax benefit theory to the balance of the deductions, and direct the Court to determine the profit on the sale without allocation of capitalized drilling and development costs.

All of which is respectively submitted.

John E. Hughes,
Harold E. Rorschach,
Counsel for Petitioners.

October 14th, 1946.

APPENDIX.

I.

Reports of American Bar Association 1943, Vol. 68, pp. 166, 167:

"Comment by the Section of Taxation: The purpose of the proposed amendment is to eliminate both retrospectively and prospectively the effect of *Virginian Hotel Corporation of Lynchburg* v. *Commissioner*, decided by the Supreme Court on June 7, 1943, in a 5 to 4 decision. The majority of the court there construes the word 'allowed' as used in Section 113(b)(1)(B), which provides that the basis of property shall be reduced by depreciation 'allowed (but not less than the amount allowable)' in prior years, to require a reduction of basis for the excessive depreciation previously deducted in error, even where the error did not benefit the taxpayer nor injure the Government. The result appears inequitable and contrary to the general rule consistently followed in tax cases that errors in prior year returns are always to be corrected and never carried forward except where some equity requires it. It is therefore believed legislation should be adopted to eliminate the effect of the court's construction of the present law."

II.

Recommendations by The Committee on Federal Taxation of The American Institute of Accountants. (The Journal of Accountancy, Dec. 1944, page 460:)

"The basis of property should not be reduced by excessive depreciation which resulted in no tax benefit.

"The requirement that excessive depreciation previously allowed be deducted in determining the basis of assets was included in the statute in order to prevent a taxpayer from obtaining a double deduction, with double tax benefit, of the same capital investment. However, that rule should not be applied when the excessive depreciation resulted in no tax benefit. The

reason for avoiding the inequitable result that formerly arose from the taxation of recoveries of bad debts and taxes, where no tax benefit had been obtained from the original deduction is equally applicable to excessive depreciation.

"For a detailed presentation of this recommendation and the arguments in its favor, reference is made to the annexed report of a subcommitee of this committee which was specially appointed to examine into this subject. (The subcommittee's report, which is omitted from this text, deals with the Supreme Court decision in the *Virginian Hotel Corporation* case and refers to amended statutory legislation proposed by the American Bar Association.)"

Montgomery Federal Taxes on Corporations 1944-45, p. 293:

"The decision has been rightly criticized as unnecessarily severe in that it penalizes the taxpayer for a mistake from which he derived no advantage."

Alexander Tax News Letter, Vol. VII, No. 50, 6/25/43:

"It is doubtful if from the ends of justice, a more unfair opinion than the *Virginian* case was ever rendered. * * * Even Godfrey N. Nelson, Tax Editor, N. Y. Times, very conservative, says Congress should enact corrective legislation and uphold Chief Justice STONE.

56 Harvard Law Review, p. 1164:

"It appears, however, that the mischief which the provision of the code in question was originally intended to correct was the situation where the taxpayer took the benefit of an excessive deduction to reduce tax liability, and then, after the Commissioner was barred from assessing a deficiency, claimed that his basis had been reduced only by the 'allowable' amount. * * * Since the excessive deductions were taken in loss years, the correction could be made without changing the tax liability for the prior years by computing the deductions

for future years as though the prior returns had been correct."

Extract From Depreciation Report of the Tax Committee of the American Mining Congress.[3]

Unless the property investment has been effectively recovered out of profits during the useful life of the property, the income of its period of usefullness has not been properly determined. The investment is not recovered out of losses but only out of profits.

The usefullness of the property will not be uniform throughout its life. Not every year will provide an equal fund from which recovery can be made. The law has very wisely made no attempt to lay down a specific formula or rule for determining the amount of depreciation which should be allowable for each year. It has only required that the allowance should be "reasonable" and it grants the reasonable allowance as a deduction from income. The difficulties come in determining the amount of that reasonable allowance, and this in turn rests to some extent on determination of the standard of reasonableness. It is to clarify this situation that the following recommendations are made:

The essence of the tax benefit rule is that no depreciation should be considered as having been allowed or allowable unless it gave a tax benefit; *i. e.*, unless it could be effectively applied to decrease taxable net income from the amount which would have been shown without such deduction.

As previously noted, recovery of basis for the property can only be made out of profits, since losses yield no fund from which investment can be recovered.

---

(3) Published by American Mining Congress, about June, 1946.

Definition of Income.

This Court has repeatedly defined "income" as used in the Sixteenth Amendment to mean "the gain derived from capital or from labor or from both combined provided it be understood to include profit gained through sale or conversion of capital assets."[4] Excessive paper deductions made in an earlier year do not fit this definition and do not become income in a later year.

This Court has said:

> "In determining the definition of the word 'income' thus arrived at, this Court has consistently refused to enter into the refinements of lexicographers or economists, and has approved, in the definitions quoted, what it believed to be the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment to the Constitution."[5]

4. See Eisner v. Macomber, 252 U. S. 189, 64 L. ed. 521.

5. Merchants Loan & Trust Co. v. Smietanka, 255 U. S. 509, 519, 65 L. ed. 751, 755.